

Office of Chief Counsel
Internal Revenue Service

memorandum

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date: January 31, 2001

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from: Associate Area Counsel, Area 3
(Retailers, Food and Pharmaceuticals)

subject: [REDACTED]
[REDACTED]
) Advisory Opinion-Reduction in Loan Payable Balance

This is in response to your memorandum dated November 13, 2000, in which you request advice concerning the taxability of certain transactions involving an [REDACTED] cooperative association.

FACTS

The essential facts are as follows. [REDACTED]
[REDACTED] (hereinafter "[REDACTED]") is [REDACTED] cooperative association that files income tax returns, Form 990-C, for its fiscal years ended on September 30. [REDACTED]'s fiscal year ended on September 30, [REDACTED] is under examination. The stated purpose of the cooperative is, in part, to provide price supports (a minimum price as determined by the [REDACTED])
[REDACTED] (hereinafter "[REDACTED]") to [REDACTED].

In order to intervene in the open market, [REDACTED] borrows funds from the [REDACTED] (hereinafter "[REDACTED]"), and uses the proceeds of these loans to buy [REDACTED] (if necessary) at the predetermined price, when the other bids involved in the sale transaction fall short of the predetermined [REDACTED] price.

During its fiscal year ended September 30, [REDACTED], the [REDACTED] assessed a penalty in the amount of \$[REDACTED] (hereinafter "the penalty") against a [REDACTED] purchaser for failing to honor an agreement to purchase [REDACTED] at a certain price. The penalty was collected by the [REDACTED] and used to pay down the loans payable owed by [REDACTED] to [REDACTED].

████ made an election under I.R.C. § 77, that was in effect during the years at issue, to treat as income the amounts it received as loans █████. See I.R.C. § 77.

ISSUE

Whether █████ realizes income under I.R.C. § 61 when the penalty proceeds assessed and collected by the █████ are applied to reduce its loan payable account to █████.

CONCLUSION

No income is realized. The payment of █████'S loans with the transfer of the penalty amounts by the █████ to █████ does not give rise to income from the discharge of indebtedness to █████ under I.R.C. § 61(a)(12) in the year of the transfer.

DISCUSSION

Section 61 defines gross income as all income from whatever source derived, except as otherwise provided by law. Section 61(a)(12) provides that gross income includes income from the discharge of indebtedness.

Section 77(a) provides that amounts received as loans from the █████ shall, if the taxpayer so elects, be included in the taxpayer's gross income for the taxable year in which the loan proceeds are received. For tax purposes, it is as if the cooperative sells the commodity to the █████ in the year the loan proceeds are received. Rev. Rul. 80-19, 1980-1 C.B. 185.

In a situation where a cooperative makes a Section 77 election and thereafter includes all loan proceeds in income at the time each loan is received, there is no additional income to be recognized, later, when the loan is paid down by an unrelated third party. The reason for this is that income has already been recognized to the full extent of the loan. There is no need to recognize income twice because to do this would be inconsistent with the Section 77 election. See Priv. Ltr. Rul. (PLR) 97-34-001 (January 9, 1997) (a coop which had made a Section 77 election did not realize additional income to the extent its loans payable to the █████ were reduced by a "surplus" payment from the USDA to the █████).

While it is clear that the reduction of [REDACTED]'s loan balance to [REDACTED] does not result in additional income to [REDACTED] at the time of the loan balance reduction, [REDACTED] must, nonetheless, reduce its basis in the [REDACTED]. See Treas. Reg. 1.1016-5(e). Section 1.1016-5(e) of the income tax regulations provides that the basis of property pledged to [REDACTED] (securing the loan) shall be increased by the amount of loan proceeds treated as income under I.R.C. § 77, and reduced to the extent of any deficiency on the loan that is forgiven. Thus, [REDACTED] could realize a gain on the subsequent sale of the [REDACTED] should [REDACTED] sell it at a price which exceeds its basis in the crop (as adjusted to account for the loan reduction).

The advice rendered herein was informally coordinated with Peter Baumgarten of Chief Counsel's National Office.

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